

October 31, 1991

**COORDINATED ISSUE
SAVINGS AND LOAN INDUSTRY
INTEREST INCOME ON THE SALE OF FORECLOSED PROPERTY**

Issue:

Whether a cash basis savings and loan must include in gross income gain from the sale of foreclosed property to the extent it represents accrued but unpaid interest (See last page for application to accrual basis taxpayers).

Facts:

This issue is addressed in Rev. Rul. 75-251, 1975-1 C.B. 175. This Revenue Ruling was validated by Gibraltar Financial Corporation of California, 60 AFTR 2d 87-5318 and First Charter Financial Corporation, 669 F.2d 1342 (9th Cir. 1982).

The fact pattern is as follows. A cash basis taxpayer who uses the reserve method, for bad debts, pursuant to IRC Sections 166 (c) and/or 593 (a), takes possession or ownership of property securing the payment of a debt after a borrower defaults. The foreclosure or similar process by which the taxpayer takes possession or ownership of the property is governed by state law. The borrower's indebtedness includes both unpaid principal and accrued but unpaid interest. The taxpayer then disposes of or sells the property at a gain in excess of its basis in the property. The taxpayer's basis in the property is defined in IRC section 595 as the "basis of the indebtedness for which such property was security (determined as of the date of the acquisition of such property) properly increased for costs of acquisition. Treas. Reg. Section 1.595-1(d) states that the taxpayer's basis in the property includes the amount of any accrued but unpaid interest on the indebtedness but only if the taxpayer has included the accrued but unpaid interest in its gross income. A cash method taxpayer would not have included the accrued but unpaid interest in its gross income, therefore its basis in the property would not include the accrued but unpaid interest.

Applicable law:

IRC Section 595 controls the tax consequences of a foreclosure and subsequent sale of property by a 593 (a) organization. It states in full:

- (a) Nonrecognition of Gain or Loss as a Result of Foreclosure. In the case of a creditor which is an organization described in section 593 (a), no gain or loss shall be recognized, and no debt shall be considered as becoming

worthless or partially worthless, as the result of such organization having bid in at foreclosure, or having otherwise reduced to ownership or possession by agreement or process of law, any property which was security for the payment of any indebtedness.

- (b) **Character of Property.** For purposes of sections 166 and 1221, any property acquired in a transaction with respect to which gain or loss to an organization was not recognized by reason of subsection (a) shall be considered as property having the same characteristics as the indebtedness for which such property was security. Any amount realized by such organization with respect to such property shall be treated for purposes of this chapter as a payment on account of such indebtedness, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to allowance of a deduction for bad debts) apply.
- (c) **Basis.** The basis of any property to which subsection (a) applies shall be the basis of the indebtedness for which such property was secured (determined as of the date of the acquisition of such property), properly increased for costs of acquisition.
- (d) **Regulatory Authority.** The Secretary shall prescribe such regulations as he may deem necessary to carry out the purposes of this section.

The Senate Finance Committee Report states that 595 was included in the Revenue Act of 1962, Pub. L. No. 87-834, Sec. 6, to eliminate the often erratic results that were produced by treating the foreclosure as a taxable event. Pursuant to IRC Sec. 595, a foreclosure is not a taxable event, and "amounts received by [a 595(a)organization] subsequent to the foreclosure are to be treated as payments on the indebtedness." S. Rep. No. 1881, 87th Cong., 2nd Sess. 47, reprinted in 1962 U.S. Code Cong. & Admin News 3297, 3550 (1962). In effect, IRC sec. 595 collapses the "foreclosure, purchase, and resale of property into a single transaction for tax purposes." First Charter, 669 F. 2d at 1347, citing Allstate Savings & Loan Association, 68 T.C. 310, 317 (1977), aff'd, 600 F. 2d 760 (9th Cir. 1979), cert. denied, 445 U.S. 962 (1980).

IRC sec. 595(b) states that property in the hands of a sec. 593(a) organization has the same "characteristics as the indebtedness for which such property was security" and "any amount realized" is considered "payment on account of such indebtedness." The Senate Finance Committee Report explains the consequences of this by stating:

When the property is ultimately sold or disposed of, the difference between the amount realized and the original or previously reduced debt is to be treated as ordinary loss or income and [sic or] is to be charged, or credited as the case may

be, against the reserve for losses on qualifying real property loans. Because the foreclosed property is to have the same characteristics as the indebtedness, where property is rented by the mutual thrift institution after foreclosure, no depreciation deduction is to be permitted.

S. Rep. No. 1881, 87th Cong., 2nd Sess. 47, reprinted in 1962 U.S. Code Cong & Admin News 3297, 3550.

As explained by the Senate Finance Committee Report, upon the sale of the foreclosed property, a taxpayer who uses the reserve method for bad debts would charge, or credit, his reserve depending on whether the gain from the sale was less than, or greater than, his basis in the property.

Argument:

The issue arises when the proceeds from the sale are in excess of a cash method taxpayer's basis and there is accrued but unpaid interest on the original indebtedness. The Service's position is that for a cash method taxpayer the proceeds in excess of basis, to the extent of the accrued but unpaid interest on the original indebtedness, must be included in gross income. Gibraltar 825 F. 2d at 1570; First Charter, 669 F. 2d at 1347; Rev. Rul. 75-251. A gain in excess of the cash method taxpayer's basis plus accrued but unpaid interest would be credited to the taxpayer's reserve for bad debts as explained by the Senate Finance Committee Report. Essentially a portion of the gain is being carved out for inclusion in gross income to the extent it represents accrued but unpaid interest.

Application To Accrual Basis Taxpayers:

It should be noted that an accrual method taxpayer would normally have included the unpaid interest in gross income as it accrued, and as a consequence the taxpayer would have increased its basis in the property under Treas. Reg. Sec. 1.595-1(d). If all accrued interest has already been included in gross income, recovery of the interest upon the sale of foreclosed property cancels out the increase in basis so no credit is assigned to the bad debt reserve.

If an accrual basis taxpayer did not accrue the interest income prior to the foreclosure, they would be in the same position as a cash method lender and would be required to carve out the interest portion as reportable gross income. This position is supported by the Gibraltar decision.

Footnote 2 of that decision refers to the body of case law which deemed a lender to

have received ordinary income to the extent of accrued but unpaid interest upon the acquisition of property in a foreclosure which developed prior to the enactment of section 595. It states: "This body of case law did not apply to an accrual basis mortgagee who had already reported the interest as income prior to the foreclosure, which would generally be the case. If the interest income were not properly accruable (e.g. because collection was too uncertain) an accrual method lender would be on the same footing as a cash method lender. See Corn Exch. Bank v. United States, 37 F 2d 34, 35." Gibraltar Financial Corporation, 60 AFTR 2d 87-5318 at 5321.

The Court further stated "Section 595 applies not only to the reserve method taxpayers of section 593, but also to non-reserve method taxpayers. We see no policy reason that requires overturning the treatment of recovered interest when that was the situation under section 593 prior to the 1962 amendments." Gibraltar Financial Corporation, 60 AFTR 2d 87-5318 at 5322.